FUTURES BROKERAGE ACTIVITIES AND FUTURES COMMISSION MERCHANTS

INTRODUCTION

Bank holding company subsidiaries, banks (generally through operating subsidiaries), Edge Act corporations, and foreign banking organizations (FBOs) operating in the United States may operate futures brokerage and clearing services involving all types of financial and nonfinancial futures contracts and options on such futures. These activities can involve futures exchanges and clearing houses throughout the world. In general, most U.S. institutions conduct these activities as futures commissions merchants (FCMs). FCM is the term used in the Commodity Exchange Act to refer to registered firms that are in the business of soliciting or accepting orders, *as broker*, for the purchase or sale of any exchange-traded futures contract and options on futures contracts. In connection with these activities, institutions may hold customer funds, assets, or property and may be members of futures exchanges and/or their associated clearing houses. They may also offer related advisory services as registered commodity trading advisors (CTAs).

The Federal Reserve has a supervisory interest in ensuring that banking organizations subject to its oversight conduct futures brokerage activities in a safe and sound manner and consistent with Regulations Y and K, including any terms and conditions contained in Board orders for a particular organization. Accordingly, where such activities exist, review of futures brokerage activities is an important element in conducting inspections of bank holding companies (BHCs), examinations of state member banks, and reviews of FBO operations. In response to recent changes in Regulation Y, the increased scope of futures activities conducted by different types of banking organizations worldwide, and general supervisory initiatives to effect more risk-focused and burden sensitive approaches to supervision, the Federal Reserve is issuing the following guidance for use in evaluating the futures brokerage activities of bank holding company subsidiaries, Edge Act corporations or foreign banking organizations operating in the U.S., or any operating subsidiaries of State member banks. The guidance provides a discussion of examiner considerations regarding FCM activities and their risks. Procedures that may be used to tailor the scope of an examination or inspection of these activities at individual institutions will be incorporated into the appropriate Federal Reserve examination manuals. For the purposes of this discussion, the term "FCM activities" is used to refer to all of an institution's futures brokerage activities and operations.

SCOPE OF GUIDANCE

The following discussion represents a substantial revision from prior guidance applicable to FCM subsidiaries of bank holding companies. In this sense, examiners are instructed to take a risk-based examination approach to evaluating FCM activities -- including brokerage, clearing, funds management, and advisory activities. Significant emphasis should be place on evaluating the adequacy of management and of the management processes used to control the credit, market, liquidity, reputation, and operations risks entailed in these operations. Both the adequacy of risk management as well as the quantitative level of risk exposures should be assessed as appropriate to the scope of the FCM's activities. The objectives of a particular inspection or examination should dictate the FCM activities to be reviewed and set the scope of the inspection.

Examiners also are instructed to take a functional regulation approach in order to minimize duplicative inspection and supervisory burdens. Reviews and reports of functional regulators should be utilized to their fullest extent. However, when there has been no recent oversight inspection, or when particular facts and circumstances at the banking organization or in the marketplace deem it necessary, a review of operations normally assessed by the appropriate commodities regulator such as front and/or back office operations may be appropriate.

When futures brokerage occurs in more than one domestic or foreign affiliate, examiners should assess the adequacy of the management of the futures brokerage activities of the consolidated financial organization to ensure that the parent organization recognizes and effectively manages the risks posed by its various futures subsidiaries. Accordingly, in reviewing futures brokerage operations, examiners should identify all bank holding company, bank operating, or FBO subsidiaries that engage in FCM activities and the scope of those activities. Not all subsidiaries may need to be reviewed for purposes of making an assessment of risk management by the consolidated organization; the selection of particular FCM subsidiaries to be reviewed should be based on an assessment of the risks posed by their activities to the consolidated organization.

The guidance presented here primarily addresses the assessment of activities associated with futures brokerage operations. Any proprietary trading that occurs at an FCM should be assessed in connection with the review of proprietary trading activities of the consolidated financial organization using the appropriate guidance contained in the Federal Reserve's Trading Activities Manual. Similarly, where a review of futures advisory activities is planned, examiners should refer to investment advisory inspection guidance contained in the Bank Holding Company Inspection Manual and the Trust Examination Manual as appropriate.

EVALUATION OF THE RISK MANAGEMENT OF FCMS

Consistent with existing Federal Reserve policies, examiners should evaluate the risk management practices of FCM operations and ensure that this evaluation is incorporated appropriately in the rating of risk management under the bank (CAMEL), BHC (BOPEC), and FBO (ROCA) rating systems. Accordingly, examiners should place primary consideration on findings related to the adequacy of: 1) board and senior management oversight; 2) policies procedures and limits used to control risks; 3) risk measurement, monitoring, and reporting systems; and, 4) internal controls and audit programs. General considerations in each of these areas are discussed below, while more detailed guidance relating to the specific risks involved in FCM activities are presented in subsequent sections of this document.

Board and Senior Management Oversight - The board of directors has the ultimate responsibility for the level of risks taken by the institution. Accordingly, the board, a designated subcommittee of the board, or high level of senior management should approve overall business strategies and significant policies that govern risk taking in the institution’s FCM activities. In particular, the board, or a committee thereof, should approve policies that identify authorized activities and managerial oversight, and articulate risk tolerances and exposure limits of FCM activities. The board also should monitor the performance and risk profile of its FCM activities. The board and senior management should review periodically information that is sufficient in detail and timeliness to allow them to understand and assess the various risk involved in these activities. In addition, the board or a delegated committee should periodically reevaluate the institution's business strategies and major risk management policies and procedures, placing special emphasis on the institution's financial objectives and risk tolerances.

For their part, senior management of the FCM is responsible for ensuring that there are adequate policies and procedures for conducting FCM activities on both a long-range and day-to-day basis. These policies should be approved and reviewed annually by senior management or a designated subcommittee of the board and consistency with parent company limits or other directions pertaining to the FCM's activities should be confirmed. Management also must maintain: 1) clear lines of authority and responsibility for managing operations and the risks involved; 2) appropriate limits on risk taking; 3) adequate systems and standards for measuring and tracking risk exposures and measuring financial performance; 4) effective internal controls; and, 5) a comprehensive risk reporting and risk management review process. In order to provide adequate oversight, management should fully understand the risk profile of their FCM activities. Examiners should review the reports to senior management and evaluate whether they provide both good summary information and sufficient detail to enable management to assess and manage the FCM's risk. As part of their oversight responsibilities, senior management should review periodically the organization's risk management procedures to ensure that they remain appropriate and sound.

Management also should ensure that activities are conducted by competent staff with technical knowledge and experience consistent with the nature and scope of the institution's activities. There should be sufficient depth in staff resources to manage these activities if key personnel are not available. Management should ensure that there are sufficient back office and financial control resources to effectively manage and control risks. Risk measurement, monitoring and control functions should have clearly defined duties, and care should be taken to ensure that there is adequate separation of duties in key elements of the risk management process to avoid potential conflicts of interest. The nature and scope of such safeguards should be in accordance with the scope of the FCMs activities.

Policies, Procedures and Limits - FCMs should maintain written policies and procedures that clearly outline their approach for managing futures brokerage and related activities. Such policies should be consistent with the organization's broader business strategies, capital adequacy, technical expertise, and general willingness to take risk. Policies, procedures and limits should address the relevant credit, market, liquidity, reputation, and operations risks in light of the scope and complexity of the FCM's activities. Policies and procedures should establish a logical framework for limiting the various risks involved in an FCM's activities and should clearly delineate lines of responsibility and authority over these activities. They also should address the approval of new product lines, strategies, and other activities, conflicts of interest including transactions by employees, and compliance with all applicable legal requirements. Procedures should incorporate and implement relevant policies of the parent company, and should be consistent with Federal Reserve Board regulations and any applicable Board orders.

A sound system of integrated limits and risk taking guidelines is also an essential component of the risk management process. Such a system should set boundaries for organizational risk-taking and should also ensure that positions that exceed certain predetermined levels receive prompt management attention, so that they can be either reduced or prudently addressed.

Risk Measurement Monitoring and Reporting - An FCM's system for measuring the credit, market, liquidity and other risks involved in its activities should be as comprehensive and accurate as practicable and should be commensurate with the nature of its activities. Risk exposures should be aggregated across customers, products, and activities to the fullest extent possible. Examiners should evaluate whether the risk measures and the risk measurement process are sufficiently robust to reflect accurately the different types of risks facing the institution. Institutions should establish clear standards for measuring risk exposures. Such standards should provide a common framework for limiting and monitoring risks and should be understood by all relevant personnel.

An accurate, informative, and timely management information system is essential to the prudent operation of an FCM. Accordingly, the examiner's assessment of the quality of the management information system is an important factor in the overall evaluation of the risk management process. Appropriate mechanisms should exist for reporting risk exposures and financial performance of the FCM to its board, the FCM's parent, and for internal management purposes. FCMs must establish management reporting policies to apprise its board of directors and senior management of material developments, the adequacy of risk management, operating and financial performance, and material deficiencies identified during reviews by regulators and by internal or external audits. The FCM also should provide reports to the parent company (or in the case of foreign-owned FCMs -- to its U.S. parent organization, if any) of financial performance, adherence to risk parameters and other limits and controls established by the parent for the FCM, and any material developments, including findings of material deficiencies by regulators. Examiners should determine the adequacy of an FCM's monitoring and reporting of its risk exposure and financial performance to appropriate levels of senior management and to the board of directors.

Internal Controls - An FCM's internal control structure is critical to the safe and sound functioning of the organization generally and to its risk management system, in particular. Establishing and maintaining an effective system of controls, including the enforcement of official lines of authority and the appropriate separation of duties--such as trading, custodial, and back-office--is one of management's more important responsibilities. Appropriately segregating duties is a fundamental and essential element of a sound risk management and internal control system. Failure to implement and maintain an adequate separation of duties can constitute an unsafe and unsound practice and possibly lead to serious losses or otherwise compromise the financial integrity of the FCM.

When properly structured, a system of internal controls promotes effective operations and reliable financial and regulatory reporting, safeguards assets, and helps to ensure compliance with relevant laws, regulations, and institutional policies. Ideally, internal controls are tested by an independent internal auditor who reports directly either to the institution's board of directors or its designated committee. Personnel performing these reviews should be independent of the function they are assigned to review. Given the importance of appropriate internal controls to banking organizations of all sizes and risk profiles, the results of audits or reviews, whether conducted by an internal auditor or by other personnel, should be adequately documented, as should management's responses to them. In addition, communication channels should exist that allow negative or sensitive findings to be reported directly to the board of directors or to the relevant board committee.

BACKGROUND ON FUTURES EXCHANGES, CLEARING HOUSES, AND FCMS

Futures exchanges provide auction markets for standardized futures and options on futures contracts. In the United States and in most other countries, futures exchanges, and FCMs are regulated by a governmental agency. Futures exchanges are membership organizations and impose financial and other regulatory requirements on members, particularly those that do business for customers as brokers. In the United States, and most other countries, futures exchanges also have quasi-governmental (i.e. self regulatory) responsibilities to monitor trading and prevent fraud, and have authority to discipline or sanction members that violate exchange rules. FCMs may be members of the exchange on which they effect customers trades. Where they are not members, FCMs must use other firms who are exchange members to execute trades.[1]

Each futures exchange has an affiliated clearing house responsible for clearing and settling trades on the exchange and managing associated risks. When a clearing house accepts transaction information from its clearing members, it generally guarantees performance of the transaction to each member and becomes the counter party to the trade (i.e., the buyer to every seller and the seller to every buyer). Daily cash settlements are paid or collected by clearing members through the clearing house. The cash transfers represent the difference between the original trade price and daily official closing settlement price for each commodity futures contract. The two members settle their sides of the transaction with the clearing house, usually

---

[1] A firm or trading company that maintains only a proprietary business may become a member of an exchange without registering as an FCM.

by closing out the position prior to delivery of the futures contract or the expiration of the option on futures contract.

An exchange member that wishes to clear and/or settle transactions for itself, customers, other FCMs, or commodity professionals (locals, market makers) may become a member of the affiliated clearing house (clearing member) if it is able to meet the clearing house financial eligibility requirements. In general, such requirements are more stringent than those for exchange membership. For example, a clearing member usually is required to maintain a specified amount of net capital in excess of the regulatory required minimum, and make a guaranty deposit as part of the financial safeguards of the clearing house. The size of the deposit is related to the scale of the clearing member's activity. If it is not a member of the clearing house for the exchange on which a contract is executed, an FCM must arrange for another FCM that is a clearing member to clear and settle its transactions.[2]

Margin requirements are an important risk management tool for maintaining the financial integrity of clearing houses and their affiliated exchanges. Clearing houses require their members to post initial margin (performance bond) on a new position in order to cover potential credit exposures borne by the clearing house. The clearing firm, in turn, requires its customers to post margin. At the end of each day, and on some exchanges on an intra-day basis, all positions

---

[2] The non-member FCM opens an account, usually on an "omnibus" basis, with the clearing member FCM. Separate omnibus accounts have to be maintained for customer and non-customer or proprietary trading activity. If the FCM does not "carry" customer accounts by holding customer funds and maintaining account records, the clearing member will carry the customer's account on a "fully disclosed" basis and issue confirmations, account statements, margin calls, etc., directly to the customer on behalf of the introducing FCM. In such cases, the introducing FCM operates as an introducing broker ("IB") and could have registered with CFTC as such.

are "marked to the market." Clearing members with positions that have declined in value pay that amount in cash to the clearing house which then pays clearing members holding positions that have increased in value on that day. This process of transferring gains and losses among clearing member firms is intended to eliminate periodically credit risk exposure from the clearing house and is known as collecting variation margin.[3] In volatile markets, a clearing house may call for additional variation margin during the trading day, sometimes with only one hour's notice, and failure to meet a variation (or initial) margin call is treated as a default to the clearing house.

Some clearing houses also require their members to be prepared to pay loss sharing assessments that may arise from losses sustained by the clearing house in meeting the settlement obligations of a clearing member that has defaulted on its (or its customers') obligations. Such assessments arise when losses exceed the resources of defaulting members, the guaranty fund, and other surplus funds of the clearing house. Each clearing house has its own unique loss sharing rules.[4] At least one U.S. and one foreign exchange have unlimited loss sharing requirements. Most U.S. clearing houses relate loss sharing requirements to the size of a member's business at the clearing house. Given the potential drain on an institution's financial resources, the exposure to loss sharing agreements should be a significant consideration in an institution's decision to become a clearing member.

---

[3] Some foreign exchanges do not allow withdrawal of unrealized profits as mark-to-market variation.

[4] Clearing houses usually retain the right to use assets owned by clearing members but under the control of the clearing house (e.g., proprietary margin); require additional contributions of funds or assets or require the member to purchase additional shares of the clearing house; or perfect a claim against the member for its share of the loss.

THE COMMODITIES EXCHANGE ACT, COMMODITY FUTURES TRADING COMMISSION AND THE SELF REGULATORY ORGANIZATIONS

In the U.S., the primary regulator of exchange-traded futures activities is the Commodity Futures Trading Commission (CFTC), which was created by and derives its authority from the Commodity Exchange Act (CEA). The CFTC has adopted registration,[5] financial responsibility, antifraud, disclosure, and other rules for FCMs and CTAs and has general enforcement authority over commodities firms and professionals that buy or sell exchange-traded futures contracts.

The futures exchanges, in addition to providing a market place for futures contracts, are deemed to be self-regulatory organizations (SROs) under the CEA. For example, a number of SROs have adopted detailed uniform practice rules for FCMs, including "know your customer" record keeping rules, and other formal customer disclosure requirements. The National Futures Association (NFA) also is an SRO although it does not sponsor a futures exchange or other market place. The NFA has adopted sales practice rules applicable to members who do business with customers. All FCMs that wish to accept orders and hold customer funds and assets must be members of the NFA.

The CEA and rules of the CFTC require the SROs to establish and maintain enforcement and surveillance programs for their markets and to oversee the financial responsibility of their members.[6] The CFTC has approved an arrangement under which a designated SRO (DSRO) is

---

[5] Many FCMs also are SEC-registered as broker-dealers and are subject to SEC and CFTC financial responsibility rules.

[6] CFTC Rule 1.51, contract market program for enforcement. The SROs monitor market activity and trading practices in their respective markets; perform on-site examinations (audits) of member's books and

responsible for performing on-site audits and reviewing periodic reports of a member-FCM that is a member of more than one futures exchange. The NFA is the DSRO for FCMs that are not members of any futures exchange

Oversight of FCMs is accomplished through annual audits by the DSRO and the filing of periodic financial statements and early warning reports by FCMs per CFTC and SRO rules. In summary, this oversight encompasses the following three elements.

1. *Full scope audits at least once every other year* of each FCM that carries customer accounts. Audit procedures conform to a Uniform Audit Guide developed jointly by the SROs. The primary focus of the full scope audit is the firm's net capital computations, segregation of customer funds and property, financial reporting, record keeping, and operations.[7] The audit also reviews sales practices (i.e., customer records, disclosures, advertisements, customer complaints) and adequacy of supervision of employees. The audit's scope should reflect the FCM's prior compliance history as well as the examiner's on-site evaluation of the firm's internal controls. During the off-year, the DSROs perform limited scope audits of member-FCMs. This audit is limited to financial matters such as a review of the FCM's net capital computations, segregation of customer funds, and books and records.

---

records, review periodic financial reports filed by members; and bring disciplinary and corrective actions for violations of the CEA, and of CFTC and SRO rules.

[7] If an FCM is also a broker-dealer, the DSRO is not required to examine for compliance with its net capital requirements if it confers with the broker-dealer's examining authority at least annually to determine that the FCM is in compliance with the broker-dealer's net capital requirements and receives copies of all examinations.

2. *FCM quarterly financial reporting requirements.* FCMs are required to file with their DSROs quarterly financial statements (1 FR-FCM). The fourth quarter statement must be filed as of the close of the FCM's fiscal year and must be certified by an independent public accountant. The filings generally include statements regarding changes in ownership equity; current financial condition; changes in liabilities subordinated to claims of general creditors; computation of minimum net capital; segregation requirements and funds in segregation for customers; secured amounts and funds held in separate accounts; and any other material information relevant to the firm's financial condition. The certified year-end financial report also must contain statements of income and cash flows.

3. Early warning reports. FCMs are required to give notice to the CFTC and the SROs when certain financial weaknesses are experienced.[8] For example, if an FCM's net capital falls to a specified warning level, it must file a written notice within five business days and file monthly financial reports (Form 1-FR-FCM) until its net capital meets, or exceeds, the warning level for a full three months. If an FCM's net capital falls below the minimum required, it must cease doing business and give telegraphic notice to the CFTC and any commodities or securities SRO of which it is a member. Similar notices must be given by a clearing organization or carrying FCM when it determines that a position of an FCM must be liquidated for failure to meet a margin call or other required deposit.

---

[8] CFTC Rule 1.12 requires the maintenance of minimum financial requirements by FCMs and introducing brokers. These requirements are similar to those applicable to broker-dealers under SEC rules.

FEDERAL RESERVE REGULATION OF FCMS

Bank holding companies are permitted, under Regulation Y, to engage in FCM and CTA activities on both domestic and foreign futures exchanges through separately incorporated nonbank subsidiaries. As a general matter, the nonbank subsidiaries of bank holding companies (and some foreign banks) provide services to unaffiliated customers in the United States under section 4(c)(8) of the Bank Holding Company Act (BHC Act), and to unaffiliated customers outside the United States under Regulation K.[9] Banks and the operating subsidiaries of banks usually provide futures-related services to unaffiliated parties in the United States under the general powers of the bank, and, under Regulation K, to unaffiliated parties outside the United States. These various subsidiaries may provide services to affiliates under 4(c)(1)(C) of the BHC Act.

Regulation Y permits a bank holding company subsidiary that acts as an FCM to engage in other activities in the subsidiary, including futures advisory services and trading, as well as other permissible securities and derivatives activities as defined in sections 225.28(b)(6) (financial and investment advisory activities), and 225.28 (b)(7) (agency transactional services for customer investments). Section 225.28(b)(7) specifically authorizes FCMs to provide agency

9 Those nonbank subsidiaries that operate in the U.S. may open offices outside the U.S. if (I) the bank holding company's authority under Regulation Y is not limited geographically, (ii) the foreign office is not a separately incorporated entity, and (iii) the activities conducted by the foreign office are within the scope of the bank holding company's authority under Regulation Y. In addition, a bank holding company may operate a limited foreign-based business in the U.S. under Regulation K.

services for unaffiliated persons in execution, clearance, or execution and clearance of *any* futures contract and option on a futures contract traded on an exchange in the U.S. and abroad. It also includes the authority to engage in other agency-type transactions, (e.g., riskless principle), involving a forward contract, option, future, option on a future and similar instruments. The section also codifies the longstanding prohibition against a parent bank holding company from issuing any guarantees or otherwise becoming liable to an exchange or clearing house for transactions effected through an FCM except for the proprietary trades of the FCM and those of affiliates.

A "well-capitalized" and "well-managed" bank holding company, as defined in sections 225.2(r) and (s) of Regulation Y, respectively, may commence activities as an FCM or a CTA by filing a notice prescribed under section 225.23(a) of Regulation Y. Bank holding companies that are not eligible to file notices or wish to act in a capacity other than as an FCM or CTA, such as a commodities pool operator, must follow the application process, and examiners should ensure that such activities are conducted in accordance with the Board's approval order.

A bank holding company, bank or FBO parent company of an FCM is expected to establish specific risk parameters, and other limits and controls on the brokerage operation that are designed to manage financial risk to the consolidated organization, and that are consistent with its business objectives and over all risk appetite.

PARTICIPATION IN FOREIGN MARKETS

Institutions frequently transact business on foreign exchanges either as exchange or clearing house members or through third party brokers that are members of the foreign exchange. The risks posed by doing business in foreign markets generally parallel those posed in U.S. markets; however, there are additional unique issues relative to doing business on foreign futures exchanges that must be addressed by the FCM and its parent company in order to ensure that the activity does not pose undue risks to the consolidated financial organization.

In this regard, before doing business on a foreign exchange, an FCM should understand the legal and operational differences between the foreign exchange and U.S. exchanges. For example, the FCM should be knowledgeable about local business practices and legal precedents pertaining to doing business in the foreign market. In addition, the FCM should know how the foreign exchange is regulated and how it manages risk, and should develop policies and the appropriate operational infrastructure of controls, procedures, and personnel to manage the risks involved in conducting business on the foreign exchange. Accordingly, examiners should confirm that, in considering whether and how to participate in a foreign market, an FCM has performed due diligence on relevant legal and regulatory issues, as well as on local business practices. The FCM should have adequate operational infrastructures to manage the risks involved in conducting business on a foreign exchange. These risks should be understood and authorized by the FCM's parent company, and any limits set by the parent company or FCM management should be carefully monitored. As discussed below in connection with exchange and clearing house membership, the FCM and its parent company also should assess the regulatory and financial risks associated with exchange and clearing house membership in a foreign market, including an understanding of the extent to which the foreign clearing house monitors and controls day-to-day credit risk, and its loss sharing requirements.

SPECIFIC RISKS AND RISK MANAGEMENT CONSIDERATIONS

In general, FCMs face five basic categories of risk - credit risk, market risk, liquidity risk, reputation risk, and operations risk. The following discussions highlight specific considerations in evaluating the key elements of sound risk management as they relate to these risks. The compliance and internal controls functions provide the foundation for managing the risks of an FCM.

CREDIT RISK

FCM's encounter a number of different types of credit risks. The following discusses eight major categories of credit risks and discuss sound risk management practices applicable to each.

Customer Credit Risk - Customer credit risk is the potential that a customer will fail to meet its variation margin calls, or its payment or delivery obligations. An FCM should establish a credit review process for new customers that is independent of the marketing/sales function. It is not unusual for the FCM's parent company (or banking affiliate) to perform the credit evaluation and provide the necessary internal approvals for the FCM to execute and clear futures contracts for particular customers. In some situations, however, the FCM may have the authority to perform the credit review internally. Examiners should determine how customers are approved and confirm that there is adequate documentation in the customer's credit files even when the approval is performed by the parent. Customer credit files should indicate the scope of the credit review and contain approval of the customer's account and credit limits. For example, customer credit files may contain recent financial statements, sources of liquidity, trading objectives and any other pertinent information used to support the credit limits established for the customer. In addition, customer credit files should be updated periodically.

FCM procedures should describe how customer credit exposures will be identified and controlled. For example, an FCM could monitor a customer's transactions, margin settlements, or open positions as a means of managing the customer's credit risk. Moreover, there should be procedures in place to handle situations in which the customer has exceeded credit limits. Procedures should delegate authority to approve limit exceptions to senior managers who are independent of the marketing/sales function and require that such exceptions be documented.

Customer Financing Risk **-** Several exchanges, particularly in New York and overseas, allow FCMs to finance customer positions. These exchanges allow an FCM to lend initial and variation margin to customers subject to taking the capital charges under the CFTC's (or SEC) capital rules if it is not repaid within three business days. In addition, some exchanges allow FCMs to finance customer deliveries, again subject to a capital charge.

An FCM providing these services should adopt financing policies and procedures that identify customer credit standards. The financing policies should be approved by the parent company and should be consistent with its risk appetite. In addition, an FCM should establish overall lending limits for each customer based on a credit review of the customer that is analogous to that performed by a bank with similar lending services. The process should be independent of the FCM's marketing/sales and financing functions but may be performed by the FCM's banking affiliate. Examiners should determine how customer financing decisions are made and confirm that there is adequate documentation, even when the approval is done by an affiliate. In addition, the FCM should review customer financial information periodically and adjust lending limits when appropriate.

Clearing-Only Risk - FCMs often enter into agreements to clear, but not execute, trades for customers. Under a "clearing-only" arrangement, the customer gives its order directly to an executing FCM. The executing FCM then gives the executed transaction to the clearing FCM which is responsible for accepting and settling the transaction. Customers often prefer this arrangement because it provides the benefits of centralized clearing (record keeping and margin payments) with the flexibility of using a number of specialized brokers to execute transactions.

FCMs entering into clearing-only arrangements execute written "give-up" agreements which are tri-party contracts that set forth the responsibilities of the clearing FCM, the executing FCM, and the customer. Most FCMs use the "Uniform Give-Up Agreement" prepared by the Futures Industry Association, although some FCMs still use their own give-up contracts. The Uniform Give-Up Agreement permits a clearing FCM, upon giving prior notice to the customer and the executing FCM, to place limits or conditions on the transactions it will accept to clear or to terminate the arrangement. If an executed transaction exceeds those limits, the FCM may decline to clear the transaction unless it is acting as the "qualifying" or "primary" clearing FCM for the customer and has not given prior notice of termination, as discussed further below.

Because clearing-only arrangements can present significant credit risks for an FCM, an FCM's risk management policies and procedures for clearing-only activities should address the qualifications required of clearing-only customers and their volume of trading, the extent to which customer trading activities can be monitored by the clearing-FCM at particular exchanges, and how aggregate risk will be measured and managed.

The FCM should establish trading limits for each of its clearing-only customers and have procedures in place to monitor their intra-day trading exposures. The FCM should take appropriate action to limit its liability if a clearing-only customer has exceeded acceptable trading limits either by reviewing and approving a limit exception or by rejecting the trade. Examiners should confirm that the FCM formally advises (usually in the give-up agreement) its customers and their executing FCMs of the trading parameters established for the customer. Examiners also should confirm that FCM personnel responsible for accepting or rejecting an executed trade for clearance have sufficient current information to determine whether the trade is consistent with the customer's trading limits. It would be prudent for give-up agreements (or other relevant documents such as the customer account agreement) to permit the FCM to adjust the customer's transaction limits when appropriate in light of market conditions or changes in the customer's financial condition.

Some FCMs act as the "primary" clearing firm (also referred to as the "sponsoring" or "qualifying" firm) for customers.[10] A primary clearing firm guarantees to the clearing house that it will accept and clear *all* trades submitted by the customer or executing FCM, even if the trade is outside the agreed-upon limits. Because an FCM is obligated to accept and clear all trades submitted by its primary clearing customers, it is particularly important that the FCM be able to monitor its customers' trading activities on an intra-day basis for compliance with agreed trading limits. Monitoring is especially important during times of market stress. The FCM should be

[10] Primary-clearing customers include institutions and individuals, as well as other non-clearing futures professionals (locals or floor traders) who execute their own trades on the exchange and other non-clearing FCMs that execute trades for unaffiliated customers.

ready and able to take immediate steps to address any unacceptable risks that arise, e.g., by contacting the customer to obtain additional margin or other assurances; by approving a limit exception; by taking steps to liquidate open customer positions; or by giving appropriate notice of termination of the clearing arrangement to enable it to reject future transactions.

Intra-day monitoring techniques will vary depending on the technology available at the particular exchange. A number of the larger, more automated U.S. exchanges have developed technologies that permit multiple intra-day collection, matching, and reporting of trades -- although the frequency of such reconciliations varies. On exchanges that are less automated, the primary clearing FCM must develop procedures for monitoring clearing-only risks. For example, the FCM could maintain a significant physical presence on the trading floor to monitor customer trading activities and to promote more frequent collection (and tallying) of trade information from clearing-only customers. The resources necessary for such monitoring obviously will depend on the physical layout of the exchange -- the size of the trading floor and the number of trading pits, the floor population and daily trading volumes, and the level of familiarity the FCM has with the trading practices and objectives of its primary-clearing customers. The FCM should be able to increase its floor presence in times of market stress.

Carrying Broker Risk - An FCM may enter into an agreement with another FCM to execute and clear transactions on its behalf (typically, when the FCM is not an exchange or clearing member of an exchange). In such cases, the FCM should have procedures providing for a review of the credit worthiness of the "carrying" FCM. If the FCM reasonably expects the carrying FCM to use yet another FCM to clear its transactions (e.g., if the carrying FCM enters into its own carrying broker relationship with another firm for purposes of executing or clearing transactions on another exchange), it should try to obtain an indemnification from the carrying FCM for any losses incurred on the transactions.[11] In instances where the transactions are occurring on a foreign exchange, it is important for the FCM to be knowledgeable about the legal ramifications of the carrying relationship under the rules of the exchange and laws of the host country. Moreover, it may be appropriate for the FCM to reach an agreement with its customers addressing liabilities relative to transactions effected on a non-U.S. exchange by a carrying broker.

Executing FCM Risk **-** When an FCM uses an unaffiliated FCM to execute customer transactions under a give-up arrangement, the clearing firm that sponsors the executing FCM guarantees its performance. Therefore, the FCM should review the subcontracting risk of its executing FCMs and their sponsoring clearing firms. However, unlike the clearing risk inherent in a carrying broker relationship, the subcontracting risk for an FCM using an executing FCM is limited to transaction risk (i.e., execution errors). FCM management should approve each executing broker it uses taking into consideration its reputation for obtaining timely executions and the financial condition of its sponsoring clearing firm.

Pit Broker Risk - Usually FCMs subcontract execution of their orders to unaffiliated pit brokers who accept and execute transactions for numerous FCMs during the trading day. The risk associated with using a pit broker is similar to using an executing broker and is limited to his performance in completing the transaction. If the pit broker fails, then the primary clearing firm

---

[11] The CFTC takes the position that the FCM is responsible to its customers for losses arising from the failure of the performance of a carrying broker. The industry disagrees with this position and the issue has not been resolved by the courts.

is responsible for completing the transaction. Therefore, an FCM should approve each pit broker it uses taking into consideration its reputation for obtaining timely executions as well as the resources of the pit broker's sponsoring clearing firm.

Clearing House Risk - Clearing house risk involves the potential for a clearing house to require a member to meet loss-sharing assessments due to another clearing member's failure. Before authorizing membership in an exchange or clearing house, an FCM's board of directors and its parent company must fully understand the initial and ongoing regulatory and financial requirements for members. The FCM board of directors should approve membership in a clearing house after a thorough consideration of the financial condition, settlement and default procedures, and the loss sharing requirements of the clearing house.

Particularly when considering membership in a foreign exchange or clearing house, the FCM's board should examine any regulatory and legal precedents related to how the exchange, clearing house, or host country view loss sharing arrangements. As in the U.S., some foreign clearing houses have unlimited loss sharing requirements, and some have "limited" requirements that are set at very high percentages. However, the loss sharing provisions of some of the foreign clearing houses have not yet been applied, which means that there are no legal and regulatory precedents for applying the stated requirements. In addition, the board should be apprised of any differences in how foreign accounts are viewed, for example whether customer funds are considered separate from those of the FCM; whether the relationship between an FCM and its customer is viewed as an agency rather than principal relationship, and whether there are material differences in the way futures activities are regulated.

The board also should be apprised of any material changes in the financial condition of every clearing house of which the FCM is a member. Senior management should monitor the financial condition of its clearing houses as part its risk management function.

Guarantees - FCM parent companies often are asked to provide assurances to customers and clearing houses that warrant the FCM's performance. These arrangements may take the form of guarantees or less formal letters of comfort. Under Regulation Y, a bank holding company may not provide a guarantee to a clearing house for the performance of the FCM's customer obligations. A bank holding company may provide a letter of comfort or other agreement to the FCM's customers providing that the parent (or affiliate) will reimburse the customer's funds on deposit with the FCM if they are lost as a result of the FCM's failure or default. Customers may seek this assurance to avoid losses that could arise from credit exposure created by another customer of the FCM since the clearing house may use some or all of the FCM's customer segregated funds in the event of a default by the FCM stemming from a failing customer's obligations.[12] Examiners should note any permissible guarantees for purposes of the consolidated report of the parent bank holding company as they are relevant to calculating the consolidated risk based capital of the bank holding company.

MARKET RISK

When an FCM acts as a broker on behalf of customers, it generally is not subject to market risk except to the extent that it executes customers transactions in error. In this regard, operational

---

[12] The letter of comfort would protect customers whose funds were used to cover other customer losses by the clearing house. It also should be noted that the U.S. clearing houses have "guarantee" funds that can be used to reimburse customers at the clearing house's discretion.

problems can expose the FCM to market fluctuations in contract values. Potential market risk exposure should be addressed appropriately in an FCM's policies and procedures.

LIQUIDITY RISK

Liquidity risk is the risk that the FCM will not be able to meet its financial commitments (i.e., end-of-day and intra-day margin calls) to its clearing FCM or clearing house. Clearing FCMs are required to establish an account at one of the settlement banks used by the clearing house for its accounts and the accounts of its clearing members. In some foreign jurisdictions, the central bank fulfills this settlement function. An FCM should establish and monitor daily settlement limits for its customers and should ensure that there are back-up liquidity facilities to meet any unexpected shortfalls in same day funds. In addition, FCMs should monitor the financial condition of the settlement bank it has chosen to ensure the safety of its funds and assets, and should be prepared to transfer its funds and assets to another settlement bank should the need arise.

To control other types of liquidity risks, an FCM should adopt contingency plans for dealing with liquidity demands arising from dramatic market changes. In addition, an FCM, to the extent possible, should monitor the markets it trades in to identify undue concentrations by others that could create an illiquid market, thereby creating a risk that the FCM could not liquidate its positions. Most U.S. clearing houses monitor concentrations and will contact an FCM that holds more than a certain percentage of the open interest in a product. In some situations, the exchange could sanction or discipline the FCM if it finds that the FCM, by holding the undue concentration, is attempting to manipulate the market. These prudential safeguards may not be in place on foreign exchanges; consequently, an FCM will have to establish procedures to monitor its liquidity risk on those exchanges.

REPUTATION RISK

FCMs should have reporting procedures in place that ensure that material events that raise reputation risk to the FCM and its bank affiliates are brought to the attention of senior management, the FCM board of directors, and, when appropriate, its parent company. Reports of such events to senior management of the parent bank holding company and an evaluation of their effect on the FCM will enable the parent to determine what, if any, steps should be taken to mitigate the impact of the event on the whole organization.

Commodity Trading Advisor. Acting as a commodity trading adviser (including discretionary investment advice to retail and institutional customers or commodity pools) may pose reputational and litigation risks to a CTA or FCM, particularly when retail customers are involved. Accordingly, the FCM's board should adopt policies and procedures addressing compliance with CFTC and NFA sales practice rules (including compliance with the "know your customer" record keeping rules).

OPERATIONS RISK, INTERNAL CONTROLS, AND COMPLIANCE

Operations risk is the potential that deficiencies in information systems or internal controls will result in unexpected loss. Some specific sources of operating risk that can result in unexpected losses at FCMs include inadequate procedures, human error, system failure or fraud. Inaccurately assessing or controlling operating risks is one of the more likely sources of problems facing FCMs.

Adequate internal controls are the first line of defense in controlling the operating risks involved in FCM activities. Of particular importance are internal controls that ensure the separation of duties involving account acceptance, order receipt, execution, confirmation, margin processing and accounting. Internal controls also should be established to record, track and resolve errors and discrepancies with customers and other parties.

FCMs should have approved policies that specify documentation requirements for transactions and formal procedures for saving and safeguarding important documents that are consistent with legal requirements and internal policies. Relevant personnel should fully understand the requirements. Examiners also should consider the extent to which institutions evaluate and control operating risks through the use of internal audits, contingency planning, and other managerial and analytical techniques.

Flaws in back-office or transaction processing operations can be a source of serious operating risk exposure. In conducting reviews of back-office operations, examiners should consult the appropriate chapters of the Federal Reserve's Trading Activities Manual for further guidance.

Operations risk also includes losses that could result from computer and communication systems that are unable to handle the volume of FCM transactions, particularly in periods of market stress. FCMs should have procedures that address such operations risks, including contingency plans to handle systems failures and back-up facilities for critical parts of risk management, communications, and accounting systems.

When FCMs execute and/or clear transactions in non-financial commodities, there may be instances in which an FCM must take delivery of a commodity because a customer is unable or unwilling to make or take delivery on its contract. The FCM should have in place a number of procedures it will follow to terminate its position and avoids dealing in physical commodities.

INTERNAL AUDIT

An FCM should be subject to regular internal audits to confirm that the FCM is in compliance with its own policies and procedures and is managed in a safe and sound manner. In addition, the internal audit function should review significant issues raised by compliance personnel to ensure they are resolved and should be available to pursue serious concerns raised by others within the firm. Internal audit reports should be forwarded to senior management of the FCM and material findings should be reported to the FCM board of directors and to the parent company. Frequently, the internal audit function is located at the parent and audit reports are routinely routed to senior management of the parent.

Examination / Inspection Guidance

The review of the FCM function should take a functional regulatory approach that makes extensive use of the findings of the FCM's primary regulators in assessing the FCM's operations and should identify any significant risks that the FCM poses to the parent company and affiliated banks. These risks should be assessed through a review of the adequacy of policies and procedures, internal controls and risk management functions. Compliance with policies and procedures and with any conditions imposed by regulatory authorities (including the Federal Reserve Board) on the FCM's activities should be fully reviewed.

Bank holding companies, banks, and FBOs may have more than one subsidiary that acts as an FCM in the U.S., or engages in futures transactions for customers in foreign markets. To ensure that the FCM activities of a banking organization are evaluated on a consolidated basis, a cross section of affiliated futures brokerage firms should be reviewed periodically, particularly those that present the greatest risk to the consolidated financial organization. Relevant factors to consider in identifying candidates for review include the volume of business, whether the FCM has unaffiliated customers, the number of customers, whether the firm provides customer financing, the number of brokers effecting transactions, whether exchange or clearing house memberships are involved, whether the FCM provides clearing-only services, and the date and scope of last review conducted by the Federal Reserve, SRO or other regulator.

The scope of any review to be conducted depends upon the size of the FCM and the scope of its activities. Examiners should review the most recent summary of Management Points or other inspection results issued by the FCM's SRO or regulator, and any correspondence between the FCM and any Federal Agency or SRO. Examiners should contact the regulator if there are any questions about the findings therein or the status of any open matter to determine whether the matter is material and relevant to the inspection.

Factors relevant in determining the scope of the inspection is whether the FCM has unaffiliated customers; whether it is a clearing member of an exchange, particularly of a non-U.S. exchange; whether it acts as a carrying broker on behalf of other FCMs; whether it has omnibus accounts with other brokers in markets in which it is not a member (U.S. or foreign); whether it provides advisory or portfolio management services including discretionary accounts or has been authorized to act as a commodity pool operator (CPO); whether the FCM provides clearing services to locals or market-makers, and whether it provides financing services to customers.[13]

Examiners are not expected routinely to perform a front and/or back office inspection unless material deficiencies in either the front or back office were found by the FCM's primary regulator during its most recent examination, or if the front or back office operations have not been examined by the primary regulator within the last two years. However, examiners may chose to review a small sample of accounts and transactions to confirm that appropriate controls are in place, and should confirm that the FCM has addressed operations risks in its policies and procedures. Examiners should perform a front and back office review of an FCM operating outside of the U.S.[14] In addition, there is no need to review net capital computations of U.S. FCMs since they are reviewed by the FCM's DSRO, and the FCM is subject to reporting requirements should capital fall below warning levels.

Examiners may rely on well-documented internal audit reports and work papers to verify the adequacy of risk management at the FCM. If an examiner finds that an audit adequately documents compliance with a policy or procedure pertaining to the management of the various risk assessments required by this inspection, he or she should document the audit finding in the work papers, and complete the inspection procedures in any area not adequately addressed by the audit report. Examiners should periodically "spot check" areas covered by

[13] If the FCM engages in proprietary trading for its own account, particularly for purposes other than hedging, i.e. market-making or position-taking, if the FCM act as an intermediary in any over-the-counter futures or other derivatives activities, the examiner should advise the Examiner in Charge of the inspection so that the firm's proprietary trading can be evaluated in connection with similar activities of the consolidated financial organization.

[14] The inspection procedures for reviewing front and back office operations may be found in Sections 1-183 through 1-214 of the Trading Activities Manual.

internal audits to ensure the ongoing integrity of the audit process. Examiners should be assured that internal auditors have adequate training to evaluate the FCM's compliance with its policies and procedures and with applicable laws and regulations (both inside and, if applicable, outside the U.S.).

Examiners should review the internal controls of an FCM to ensure that the firm is operated in a safe and sound manner according to industry standards and in compliance with any Board regulations or conditions placed on the FCM's activities. Examiners, generally, should be alert to any red flags indicating inadequate internal controls. In addition, an FCM must be organized so that the sales, operations and compliance functions are separate and managed independently. If an FCM engages in proprietary trading, examiners should confirm that the firm has procedures that protect against conflicts of interest in the handling of customer orders (e.g., front-running, ex-pit transactions).

The results of the review should be consolidated with the results of the reviews of other entities inspected during this cycle for purposes of making an overall assessment of the organization's futures business.